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Speed Reading: Ten Issues to Spot in a Public Company Merger Agreement

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Public company merger agreements regularly exceed 60 pages. Yet, clients often need feedback within hours of receiving the first draft. Is it possible to provide any meaningful guidance on an expedited basis? Although every deal is different, and every merger agreement requires a close read, any initial review of a draft merger agreement should focus on ten key issues. Most of the key issues relate to price and closing certainty, and focusing on these ten issues will give the deal team a sense of whether reaching a deal is achievable. These ten issues also can form the basis for an easy-to-digest comparison of competing bids.

1. Merger Consideration

Usually the first draft of a merger agreement does not include dollar amounts or a specific exchange ratio. Often this is because those matters have not yet been agreed, because the parties do not want to increase their risk of a leak of the valuation or because the parties do not want to trigger a disclosure requirement by documenting an agreed price. Even in the absence of specific price information, a quick read of the merger consideration provisions in the merger agreement can provide valuable information, including the following:

What is the proposed form of consideration (cash, stock, mixed or other)?

If stock consideration is proposed, is the exchange ratio fixed or floating? Are there any collars? Are there built-in dilution adjustments? Are there any other adjustments (for example, if the draft contemplates a fixed exchange ratio based on the parties' relative tangible book values, what is the mechanism for "bringing-down" those valuations at closing, if any)?

If mixed consideration is proposed, is there a cash election or pro rata allocation mechanism?

Are there any built-in purchase price adjustments? Are the adjustments pre-closing or post-closing? If post-closing, is there an escrow or a holdback?

> What is the proposed treatment of preferred stock, stock options, restricted stock units, share appreciation rights, warrants and other securities (e.g., cash out v. roll-over)?

In addition to spotting business issues associated with the merger consideration calculations, a quick read of the merger consideration provisions will also identify critical structuring issues, such as whether a target's preferred stock and equity awards can be cashed-out in a deal without the consent of the holders and whether a proposed cash-election mechanism is permissible under the proxy rules.

2. Deal Protections

For a variety of reasons, Delaware law virtually requires that the parties engage in some back-and-forth negotiations regarding deal-protections, which include no-shops, change in recommendation provisions and break-up fees. Key issues to identify include the following:

> Does the no-shop include a reasonable fiduciary out?
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> Can the target provide due diligence access to an interloper that has made a potential superior proposal if the interloper signs a confidentiality agreement (excluding a standstill)?
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> Does the buyer have a matching right if the target receives a superior proposal?
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> How do the notification requirements and time periods associated with the receipt of a superior proposal work? Do they give the target's board enough time and information for the directors to comply with their fiduciary duties?
>
> Can the target's board change its recommendation both for a superior proposal *and* in an "oil under the headquarters" scenario? Even if the target's board changes its recommendation, is there a "force-the-vote" (a contractual requirement that the approved deal be put to a shareholder vote no matter what happens after the deal has been agreed)?

How much is the break-up fee? Is there an additional provision for payment of expenses? Under what conditions are these fees payable? Is there a "naked no-vote" fee?

Are there any other deal protections (e.g., stock options or crown jewel options)?

If the buyer requires a shareholder vote, is the buyer subject to any deal protections?

Is there a go-shop?

3. Financing; Reverse Break-Fees; Specific Performance

How the buyer intends to line up its financing (and the question of what happens if the financing arrangements fall apart before the closing) is critical. This issue arises in cash deals in which a portion of the purchase price will be financed by third party lenders and in stock-for-stock deals in which either or both parties' existing debt will need to be refinanced to address change in control puts, ratings conditions, dividend stoppers or other restrictive covenants in the existing debt agreements.

If the buyer intends to use cash "on hand" to pay the purchase price, usually a representation and warranty that the buyer has the requisite cash available is satisfactory if it is coupled with due diligence regarding the buyer's cash position and a covenant that buyer will not take any actions between signing and closing that would cause that self-financing to become unavailable.

If the buyer requires third party financing, the ideal situation from a target's perspective is to get firm commitments from the lenders at the signing. These could take the form of U.K.-style "funds certain" commitment letters or fully documented and executed loan agreements. In practice, however, it is often not realistic to lock-in all of the details of the financing pre-signing.

In those cases where there is some uncertainty regarding financing, the parties need to allocate the risk of a failure to obtain the financing. That risk allocation involves a few key concepts: (1) the level of efforts the parties are required to take to secure the requisite financing; and (2) the consequences of a failure to obtain the requisite financing when all other closing conditions have been satisfied.

Level of Efforts to Obtain Financing. Merger agreements often include covenants that address the extent to which the buyer is required to incur costs to obtain its financing. The parties should give some thought to which buyer entity is bound by the provision (e.g., in a private equity deal, is it the fund, a guarantor or the shell acquisition vehicle?). The provision may address whether there will be a pre-closing marketing period during which the buyer can work with its primary lender to syndicate some of the debt. The merger agreement may also address whether the target is required to provide audited financial statements or solvency certificates or cause its management to participate in lender-oriented road-shows.

Consequences of Failure to Obtain Financing. This has been a hot topic in the M&A literature and much has been written regarding the relationship between specific performance provisions, reverse-break-up fees, financing conditions and the availability of damages calculated by reference to loss of market value. Suffice it to say that all of these concepts require close attention and may end up being the most contentious issue in a deal negotiation (after price). As we learned from the *United Rentals v. Cerberus* case, careful attention to detailed drafting on these issues is a must, but even a quick glance at a merger agreement can inform the reader whether the buyer's approach to conditionality is consistent with the seller's.

4. Social Issues

Social issues are issues that relate to the governance and conduct of business of the combined company following an M&A transaction. These issues are most relevant to a stock-for-stock transaction, especially a merger of equals, where each parties' shareholders have an economic interest in how the combined company is run (in contrast to a cash merger in which the target's shareholders will not have any continuing interest in the combined company).

Social issues include the following:

Composition of the combined company's board of directors;

Composition of the combined company's executive management;

Location of the combined company's headquarters;

Name of the combined company; and

Treatment of the target's employees (e.g., continuation of salary and benefits).

Fortunately, social issues are usually easy to spot in a draft merger agreement. Unfortunately, they are not so easy to resolve!

5. Reciprocity of Representations and Warranties and Interim Covenants

In cash mergers, the buyer usually makes very few representations and warranties in the merger agreement (other than basic transactional and financial solvency representations and warranties). In a cash deal, the buyer is also unlikely to agree to many restrictions on its conduct of business between signing and closing (other than, perhaps, a restriction on taking any action that would cause it to be unable to close the transaction). In contrast, in a stock-for-stock merger, it is customary for a buyer to provide more representations and warranties, just as it is customary for the buyer to give the target more access to perform due diligence on the buyer, for purposes of validating the value of the buyer's stock. It is also customary for the buyer to agree to restrictions on its interim conduct of business, especially if the buyer requires shareholder approval for the transaction. The more the transaction appears to be a merger of equals in which the buyer and the target are equal in size, the more likely it is that the buyer's and the target's representations and warranties and interim covenants will mirror each other. A quick read of a public company merger agreement can reveal whether the drafters approached a deal as a merger of equals.

6. MAEs: Definitions, Bring-Downs and Standalone Conditions

"Material adverse effect" provisions ("MAEs") always have been a hot topic for M&A practitioners. Any quick-read of a merger agreement should identify the following:

Whether the MAE definition and carve-outs are customary;

Whether MAEs are used appropriately to qualify representations and warranties;

Whether the "absence of changes" representation and warranty includes a MAE qualifier and whether the representation is "brought down" at closing (with attention to "double materiality" issues);

Whether there is a stand-alone MAE closing condition and, if so, whether it refers back just to the signing date or to the last audit date, and whether it can be qualified by reference to the disclosure schedules; and

Whether and under what conditions the parties have termination rights if a MAE occurs.

Recent cases, such as *Huntsman v. Hexion*, have continued the Delaware courts' perfect record of never finding that a MAE has occurred. That is not to say, however, that MAE clauses have no value. The absence of case law may reflect that parties seeking to exercise outs are successful in doing so on a negotiated basis (or in the settlement of litigation). Accordingly, careful attention to MAE drafted is still warranted.

7. Hell or Highwater Provisions; Drop-Dead Dates

Inextricably linked with regulatory approval closing conditions are "hell or highwater" provisions. These are covenants that specify the level of efforts a party is required to undertake in order to obtain requisite regulatory approvals (and, in some deals, requisite third party consents). Key concepts include the following:

Whether either party is required to agree to divestitures, hold separate orders, consent decrees or other restrictions and, if so, whether there is any "cap" on that obligation;

If there is such a cap, is the cap measured by reference to a specified quantitative threshold or by reference to some notion of materiality measured against the target, the buyer or the combined company, with or without taking into account the transaction synergies?

Is either party required to litigate to seek to have an adverse regulatory determination over-turned? If so, must the party pursue such litigation to the highest possible court or is it sufficient to have an adverse determination at a lower court level before the parties can part ways?

What is the drop-dead date on the deal? Does it give sufficient time to obtain the requisite regulatory approvals? Does either party have the right to extend the drop-dead date for regulatory reasons?

By when are the parties required to make all regulatory filings?

To what extent must each party cooperate with and involve the other party in discussions with regulators regarding requisite approvals?

8. Other Closing Conditions

Flag any non-standard closing conditions in a preliminary issues list. The menu of possibilities is virtually endless, including ratings conditions, conditions that specified employees be employed at the closing, minimum EBITDA and other performance-related conditions, conditions related to specified litigation matters, and conditions related to specified regulatory hurdles. Some conditions that, on their face, appear to be customary may contain traps for the unwary. For example, pay close attention to (1) any "flat" bring-down requirements (i.e., bring-down language that is not subject to MAE or other materiality qualifiers) that could be difficult to satisfy and (2) regulatory conditions relating to non-material regulatory approvals or filings. It is also important to focus on which party has the right to claim a condition has not been satisfied. Not all conditions need to be mutual but sometimes one can find surprising instances of one-sidedness in first drafts of merger agreements.

9. D&O Indemnity and Insurance

The director and officer ("D&O") indemnity and insurance provisions of a public company merger agreement are easy to overlook. They usually comprise only a few paragraphs. However, they frequently get a lot of attention from the target's directors. Key considerations include:

Is there a post-closing indemnity for the target's directors' and officers' pre-closing activities? If so, which entity is providing the indemnity (the target, the buyer or other)? Is the scope of the indemnity the same as, or greater or less than, what a corporation is allowed to provide to its own directors and officers under state law?

Is the buyer required to preserve the target's existing indemnities contained in its bylaws? Would this requirement survive a change of control of the buyer or the surviving corporation?

Is the buyer or the target required to purchase a tail policy to protect the target's directors and officers for pre-closing actions? What is the cap on premiums? Is it a Side A policy? Are the directors and officers required to seek recovery from the tail policy before seeking indemnification from the company?

Do the target's directors and officers have third party beneficiary rights to enforce the D&O indemnity provisions?

10. Tax Structure of Merger

Usually a merger agreement's recitals will reveal quickly whether the transaction is intended to be structured as tax-free or taxable to the target's shareholders. A tax specialist can verify which structure (forward, forward triangular, reverse triangular, multi-step, etc.) will achieve the desired tax treatment given the facts. The key is to make sure that the tax specialist did indeed have the relevant facts. For example, factors like the form of merger consideration and the existence of preferred stock roll-overs could impact the tax structure analysis. While these structural issues usually are not very contentious, they can require a lot of work and collaboration between the parties to develop appropriate solutions. For that reason, it is best to identify them as soon as possible and task a joint working group with fixing any disparities between the desired tax treatment and the manner in which the corporate drafts-person envisioned the transaction would be structured.

Conclusion

Public company merger agreements are complex documents that combine multiple, intersecting layers of business and legal issues. In any initial review of a draft merger agreement it is imperative that you not miss the forest for the trees. Fortunately, practices have evolved such that many sections of these agreements are virtually "boilerplate". Unless one party is particularly wedded to its own form, it is often just a matter of making sure those "boilerplate" sections actually work under the applicable facts and comply with the applicable rules, regulations and governance documents. The ten issues we outlined above, however, are not "boilerplate". They tend to be more contentious and require negotiation among the principles. They are also the sorts of issues that a board of directors usually should discuss in connection with considering whether to approve a transaction. M&A lawyers should be able to identify these issues quickly and accurately (not to mention propose ways to bridge gaps in the parties' respective positions). The sooner the principals are informed of these issues, the sooner they can negotiate any differences and get the deal announced before there is a leak or a party changes its mind.

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